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Trade

U.S. Hub-and-Spoke Bilaterals and the Multilateral Trading System

by

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How will free trade negotiations with Mexico change trade in the Americas? If a tripartite negotiation expands the 1989 Canada-U.S. Free Trade Agreement (FTA) to include Mexico (with limited exceptional provisions), each country will trade freely with all of the others. Alternatively, if Canada does not participate, the result will be a Mexico-U.S. bilateral agreement creating a "hub-and-spoke" system, with the U.S. hub having separate spoke bilaterals with Canada and Mexico — and possibly adding other spokes later.

Under an expanding FTA, all countries are likely to acquire benefits, not only as they join, but also as new partners are added.

Under a hub-and-spoke system, each spoke country can be expected to benefit from its own bilateral with the United States, but it will lose later as the United States signs bilaterals with other countries. The U.S. situation is, however, quite different: it can expect benefits as it signs each bilateral. The result, compared with an expanded FTA, will be a preferential U.S. network in which the United States will benefit from the discrimination that its spoke partners will have to face.

It is in the interests of all countries concerned — even the United States, the apparent beneficiary — to reject a hub-and-spoke system in favor of an expanding FTA. In particular, Mexico should now reject a hub-and-spoke bilateral with the United States alone, because, like Canada, it would face costs from future U.S. bilaterals with other countries. Moreover, any advantages Mexico might get from now being able to tailor its own bilateral with the United States to satisfy its special needs might be more than offset if future U.S. partners are consequently able to tailor their bilaterals, and do so at Mexico's expense.

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Introduction*

On January 1, 1989, the United States entered into a free trade agreement (FTA) with Canada. By 1993 — and perhaps earlier — it may conclude a similar agreement with Mexico. It has also indicated that it will entertain the idea of FTAs with other countries in the Americas, some of which have already expressed interest. Although it may not yet be likely, there is now the real possibility that, within the next decade, the United States will be freely trading with a substantial number of countries in the Americas, perhaps even beyond.

What will be the framework of that emerging free trade system? There are two broad possibilities:

A. A plurilateral free trade agreement by $n + 1$ countries, in which the United States and the other n countries are trading freely, with the borders of each open equally to trade with all of the others.

B. A hub-and-spoke trading system, in which the United States, as the hub in a rimless wheel, has a bilateral spoke agreement with each of the other n countries. While the United States would be trading freely with each spoke country, none of the spokes would be trading freely with any of the others (see Figure 1).

In this *Commentary*, the n countries are the same in A and B, and they are referred to as "partner countries", whether they are FTA partners of the United States in A or spoke countries to the U.S. hub in B. Obviously, there are many variants between A and B — one could have, for example, a hub-and-spoke system like B except that two of the n spoke countries have their own bilateral FTA.

Rather than analyzing such variants in detail, this *Commentary* concentrates on a comparison of the two trading regimes, A and B, in their simplest forms. They represent two entirely different approaches to liberalizing trade. Because A is far closer than B to free trade, and does not provide the United States with the central role it would have in B, the two approaches lead to two very different economic and geopolitical systems. When the United States starts to negotiate free trade with Mexico in 1990, it will, either consciously or inadvertently, be embarking on one or the other. If there is a trilateral negotiation including Canada in which the three countries expand the Canada-U.S. FTA to include Mexico, the result will be close to the plurilateral FTA in option A. On the other hand, if Canada does not participate and the United States and Mexico negotiate their own separate bilateral FTA, the result will be a hub-and-spoke system, with the U.S. hub having separate spoke bilaterals with Canada and Mexico — and quite possibly adding other spoke bilaterals later.

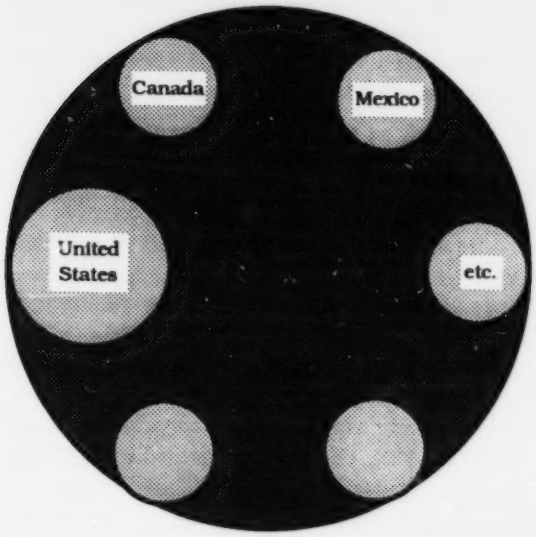
The objective of this *Commentary* is not to examine what the United States has negotiated with Canada, is negotiating with Mexico, or might negotiate with any of the other countries in the Americas, let alone beyond. Instead, the purpose is to examine the economics of the two broad options, A and B, in order to clarify where trade in the Americas is headed in this threshold period in which the risk of decision by default is high.

A process has now begun in which the negotiators may well be faced with a staggering array of bilateral detail — indeed, a negotiating agenda which may be almost impossible to complete. The danger is that they may become so preoccupied with the nuts and bolts, and elected representatives so distracted by having to deal with the political opposition to trade liberalization, that both groups may not have the opportunity to stand back and ask how the decisions taken today are likely to affect future trade in the Americas and, indeed, the world trading system. The risk is that, in responding magnanimously to requests for bilateral agreements that are in its interests and, at least initially, in those of the applicant nations, the United States could inadvertently be creating a discriminatory, inefficient, hub-and-spoke trading structure that will be unnecessarily damaging to its partners and may erode prospects for future multilateral liberalization.

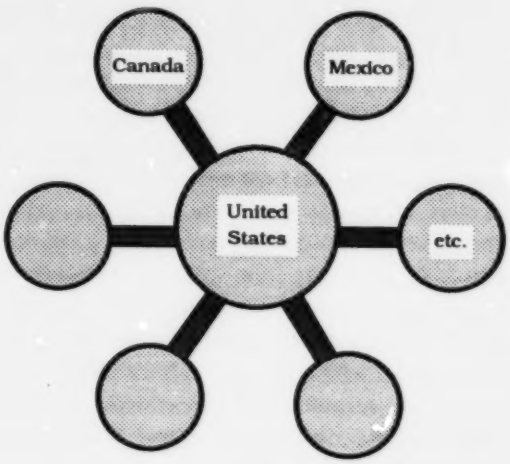
Figure 1

The Free Trade Domain:
A Free Trade Agreement Compared with a Hub-and-Spoke System

A. Plurilateral Free Trade Agreement



B. Hub-and-Spoke System



Since an FTA is the simpler form of trade liberalization — and provides the key to understanding the more complex hub-and-spoke regime — the first stage in the analysis will be a brief review in the next section of some of an FTA's important characteristics. While it beneficially creates a domain of free trade, it can also have some damaging protective effects. It may also weaken or strengthen the parallel thrust for multilateral free trade in the General Agreement on Tariffs and Trade (GATT). Because of these large pros and cons, the judgment on whether an FTA is beneficial depends heavily on the characteristics of the participants and the form of their agreement. This section concludes with the reasons why, on balance, both the creation of the bilateral Canada-U.S. FTA and its possible extension to create a trilateral Canada-Mexico-U.S. FTA are judged — even by those opposed to its further extension — to have a favorable effect.

The second stage in the analysis will be to examine how a hub-and-spoke system differs from an FTA. It will be shown that, under a hub-and-spoke system, the free trade gains will be less, and the protectionist costs will be greater. Moreover, the risks to the worldwide multilateral trading system will be greater because, if the hub-and-spoke system is extended far enough, the United States as the central hub will capture benefits — in particular, benefits in spoke markets — that it would be unable to realize not just in an expanded FTA, *but even under multilateral free trade*. This raises the possibility that the traditional support of the U.S. administration for multilateral free trade could be seriously weakened.

This second-stage comparison of a hub-and-spoke system with an FTA provides the basis for later addressing the question: Which of these two forms of free trade should be preferred by each of the interested parties in the upcoming negotiations with Mexico?

The third stage in the analysis will be to examine what happens to all countries involved if a hub-and-spoke system were to de-

velop from scratch. This is essentially the question that would have to be addressed if the United States were now to negotiate a bilateral with Mexico, and, with a resulting hub-and-spoke system in place and an expanding FTA judged to be no longer an option, the United States were then to consider similar bilaterals with other countries.

In examining the effects of the restructuring of trade barriers in a hub-and-spoke regime, I make no claim that this will be *the* issue in trade policy in the 1990s. It may be, but this will depend on how events unfold. Will the hub-and-spoke arrangements in Europe be replicated in an even more significant way in the Americas? Will Japan become a spoke in the U.S. wheel and/or will the Japanese develop their own spoke arrangements in the Far East? Whether or not history unfolds in one or more of these ways, there will be other important trade-related issues to address as well — such as the development and international transfer of technology. This *Commentary* examines the liberalization of trade, including the elimination of tariffs and other barriers to trade — "tariff" is used here to represent both. While tariffs have become less important over time, other trade barriers have become more important. The uncertainty — and hence the damaging effects on investment — from these other barriers can be substantial, even if they are seldom, if at all, used.

Although the important question of distortions to investment decisions is seldom addressed explicitly, it is implicit in this analysis. A country with a preferential trading position will offer a strong attraction for foreign investment, just as a country facing trade discrimination will find it difficult to attract investment.

What Are the Effects of a Free Trade Area?

The creation of an FTA will provide its members with gains from trade and possible costs.

Economic Benefits and Costs of an FTA

Benefits of an FTA. As barriers between two countries are eliminated, expanding trade provides real income benefits from comparative advantage, economies of scale, more competitive and hence efficient domestic markets, and the increased ability of each government to resist special-interest groups.

So long as each member country is purchasing from partner countries that are the least-cost (most efficient) source, the result is beneficial *trade creation.*

Costs of an FTA. Trade creation is not the only reason that trade between FTA members may increase. The United States, for example, may divert its purchases from the lowest-cost world source — say, Japan — to Canada, because, under the FTA, the United States favors Canadian goods over Japanese. That is, it gives Canadian goods, not Japanese goods, free access to its market. This *trade diversion*[1] involves a cost that can be briefly reviewed with the simplest possible hypothetical example.[2]

Suppose that, before any FTA is formed, the United States has a 10 percent tariff on an item bought from the Japanese for $100; because of the tariff, this item sells in the United States for $110. Suppose that the item can also be bought from Canada at a higher price — say, $104. Before the FTA, Americans do not buy the item from Canada because its price in the United States (including the U.S. tariff) is about $114. But when the FTA is formed, the U.S. tariff on the Canadian item is removed, so Americans buy it for $104, rather than for $110 — the price of the tariff-ridden Japanese item. There is a reduction in world efficiency because the United States is now buying from a higher-cost source, Canada. This loss of $4 per unit is borne by the United States: although U.S. consumers save $6 because the U.S. price is now $104 rather than $110, U.S. taxpayers lose the $10 duty previously (but no longer) collected by the U.S. Treasury.

In conclusion, the United States loses because it has engaged in *trade diversion*, switching its import purchases from Japan to a higher-cost Canadian source. Canada, as the FTA partner, benefits from the *preference* it has acquired in the U.S. market in competition with Japan. Japan, as the excluded third country, loses because of its reduced sales in the U.S. market due to the *discrimination* it faces there in competition with Canada. While this U.S. trade diversion has these different effects on all three countries,[3] collectively they lose because this good is now being produced at higher cost.

The conclusion that follows from this discussion is that an FTA may be beneficial if the benefits of trade creation exceed the costs of trade diversion,[4] or damaging if the reverse is true. In short, it may be superior or inferior to the present trading regime.

Additional Observations

First, because of the Canada-U.S. FTA, excluded countries such as Japan have an incentive to push for multilateral free trade in the GATT, since they are being discriminated against in the Canadian and U.S. markets. To escape from this discrimination, they have an incentive to seek multilateral liberalization that would eliminate all tariffs — in particular, in our example, the U.S. tariff. With this tariff falling to zero, the United States would no longer discriminate; instead, it would purchase from Japan again at the $100 price.

Second, under standard assumptions, multilateral free trade is superior to even a beneficial FTA, for two reasons: (i) it provides the same benefits of trade creation as does an FTA, but extends them over a broader, worldwide domain; and (ii) there is none of the FTA's trade diversion, since there are no excluded countries from which purchases can be diverted. It follows, then, that multilateral free trade would be better than an FTA, *if it can be negotiated*.[5] If it cannot, an FTA may offer net benefits and, therefore, may be an appropriate policy. This point can perhaps be summarized by posing the question sometimes used by supporters of a "super-GATT" of countries able and willing to negotiate freer trade among themselves in a world in which a similar move to free trade by all GATT countries cannot be negotiated: Why should trade liberalization between some countries be blocked because multilateral free trade is not feasible, perhaps due to domestic political pressures in other countries that prevent them from participating? A free trade agreement — whether in the form of a super-GATT or a free trade area — may be a way of unblocking the thrust of two or more countries to achieve trade liberalization.[6] Thus, it may be a way of getting more trade liberalization, while at the same time allowing participating countries to support multilateral free trade in the GATT.

Third, there are several reasons why the U.S.-Japan-Canada example of trade diversion above may eventually lead, not to the inefficient outcome described here, but to an efficient outcome. Consider two:

- If Canada can capture sufficient economies of scale from the Canada-U.S. FTA, the cost of producing an item here may fall enough — in the example, below $100 — to make Canada, the FTA partner, the lowest-cost source of this item, rather than Japan. In this case, both the United States and Canada benefit. This exceeds the loss to Japan — that is, all three countries collectively benefit because the item is now being efficiently produced at a lower-cost source.
- Because trade diversion lowers the domestic price of the item in the United States — from $110 to $104 — it may reduce the size and political influence of the competing domestic U.S. industry. With its political power eroded, the industry may no longer be able to retain its protection against third countries such as Japan. As the U.S. tariff against these countries erodes — suppose, in the limiting case, to zero — then all imports, from Japan as well as from Canada, enter the United States duty free. U.S. buyers will again purchase from Japan — for $100, rather than for $104 from Canada.[7] In this case, the short-run trade diver-

sion to Canada caused by the FTA disappears in the long run. The efficient purchase from Japan is restored and, indeed, increased because of the lower U.S. domestic price. Thus, instead of trade diversion, the eventual result of the FTA in this case is an *expansion of efficient trade with a country excluded from the FTA.*

To sum up so far: Even though members *may* benefit, on balance, from an FTA, it is possible that they will not, because an FTA generates both benefits and costs. However, under standard assumptions, even a beneficial FTA is inferior to multilateral free trade. Nonetheless, countries often form FTAs because they judge that they will, on balance, be beneficial and because multilateral free trade cannot be negotiated quickly, if at all.

While countries form FTAs while still working on the multilateral front, the creation of an FTA may affect the chances of negotiating multilaterally; in some respects, it may make it easier to negotiate multilateral free trade, in other respects more difficult.[8]

Assessing North American Free Trade Agreements

The Canada-U.S. FTA

Estimates of the effects of the Canada-U.S. FTA indicate that it should generate substantial net benefits. The above discussion provides some clues as to why. Broadly speaking, it is because the geographical proximity of the two countries means that transport costs of many products do not substantially dissipate their gains from trade; they have an "economically natural" FTA — that is, they trade more with each other than with anyone else and that makes it more likely that they will create, rather than divert, trade. For example, before the FTA was implemented, 70–80 percent of Canada's imports came from the United States, so that there is only a small domain of these imports — the remaining 20–30 percent — over which trade diversion from other countries to the United States might occur. True, the United States' trade is spread more evenly among countries — with only about 20 percent of its imports coming from Canada, its largest trading partner — so that there is a larger domain of about 80 percent of its imports over which it might divert some purchases from other countries to Canada. Because of substantial economies of market size, however — in particular, economies of scale — there are opportunities for Canadian costs to fall in the FTA as Canadian producers scale up to service the U.S. market. In such cases, inefficient trade diversion may become efficient, with real income rising as a consequence.

Expansion of the Canada-U.S. FTA to Include Mexico

The influences cited above in the Canada-U.S. FTA are likely to generate further benefits if that FTA is expanded to include Mexico. For example, Mexico is geographically proximate to the United States, with much of its trade centered there. This makes it more likely that the benefits of trade creation will outweigh the costs of diversion.

How, then, would such an expanded Canada-Mexico-U.S. FTA compare with the hub-and-spoke system that would be created if the United States were to negotiate a bilateral agreement with Mexico in which Canada does not participate — that is, a hub-and-spoke system in which the United States is the hub and Canada and Mexico are the two spokes?

A Hub-and-Spoke System Compared with an FTA

Consider how the choice of a hub-and-spoke system[9] over an FTA would affect each of the countries concerned.

The Hub Country Would Benefit More from a Hub-and-Spoke System

As the hub, the United States would benefit more from a hub-and-spoke system because it would get something it would not under a tripartite FTA — namely, the preference it

would get in the Mexican market in competition with Canada, and the preference it would get in the Canadian market in competition with Mexico.[10]

As *n*, the number of U.S. partners, increases, the larger becomes the domain of spoke markets over which the United States would enjoy preference in competition with all other spoke countries, and the greater becomes the advantage to the United States of a hub-and-spoke system over an FTA. (Paradoxically, as *n* increases, U.S. producers get preference in more and more foreign markets, while they lose preference — protection — in their own domestic market.) In turn, this preferential position in trade would provide the United States with a preferential position in attracting manufacturing investment. In any FTA, manufacturing is stimulated in the partner countries at the expense of excluded countries because of the typically escalated tariff structure that provides higher levels of protection for manufacturing than for resource extraction and processing. In the case of a hub-and-spoke regime, the locational advantage of the hub country in manufacturing is magnified because it is a partner in several FTAs.

Thus, in the context of this analysis, the incentives for the United States are clear. While either form of trade liberalization — a hub-and-spoke or an FTA — would provide the same benefits from elimination of barriers at the U.S. border to its trade with partner countries, the hub-and-spoke offers an advantage for the United States because of the trade barriers it would leave at the borders between its partner countries. It is these barriers that provide the United States with preference in spoke markets.

Excluded Third Countries Would Lose Less from a Hub-and-Spoke

Excluded countries, such as Japan, would be damaged by either a tripartite North American FTA or a hub-and-spoke system, because either regime would leave the Japanese facing discrimination in North American markets. They would incur less damage from a hub-and-spoke regime, however, because the discrimination they would have to face in Mexico or Canada would only be in competition with the United States. (On the other hand, with an FTA, the discrimination they would have to face would be in competition with *all* the FTA members — for example, in the Canadian market, they would face discrimination in competition with both the United States and Mexico.)

Existing U.S. Partners Would Be Worse Off under a Hub-and-Spoke

If Mexico were added to the Canada-U.S. FTA, the existing U.S. partner (Canada) would likely acquire net benefits from free trade with Mexico. While there would be substantial short-run adjustment costs because of the displacement and re-employment of labor now in low-wage Canadian jobs, there would be long-run benefits for Canada. Among these would be the benefits of trade creation with Mexico, including low-cost Mexican imports that would benefit Canadian consumers and make Canadian industry more competitive; and the benefit to Canadian exporters of duty-free access to the Mexican market, augmented by the preference over third countries that Mexico would provide.

In comparison, consider the hub-and-spoke system that would result if the United States were to add a Mexican bilateral. Since Canada would remain an excluded outsider to the new U.S.-Mexico agreement, Canada would not get the potential net benefits from Canada-Mexico free trade. For example, Canadian firms would not be able to acquire low-cost inputs from Mexico duty free as would U.S. firms. Thus, Canadian firms would be at a disadvantage in competing with U.S. firms in the U.S. market[11] and, indeed, in all other markets — including Mexico. Worse yet, in the Mexican market, Canadian firms would not get better free trade access. Quite the contrary; they would get worse access, because they

would have to face discrimination in competition with U.S. firms.

Thus, an existing partner country (Canada) in an FTA with the United States will strongly prefer that the United States include any new free trade partner (Mexico) in an expanded FTA, which would *benefit* Canada, rather than include this new partner as another spoke in a hub-and-spoke regime, which would *damage* Canada.[12]

On the face of it, the question of whether Canada and Mexico should be trading freely (in an expanded FTA) or not trading freely (in a U.S. hub-and-spoke system) seems not to be a pressing one because of the relatively small trade that now exists between the two countries. It could become a more substantial issue in the future, however, for reasons that are elaborated below. For example, trade liberalization between Canada and Mexico may substantially increase trade between them, because of the large increase in productivity and purchasing power that is likely to occur in Mexico under any form of free trade with the United States.[13]

Concluding Remarks: A Hub-and-Spoke versus an FTA

Whereas the economic issues addressed here indicate that a hub-and-spoke regime would be better for the United States than the corresponding FTA,[14] it would be worse for spoke countries. Thus, compared with an FTA, a hub-and-spoke would generate benefits for the United States at the expense of its partners. As the number of participating countries, *n*, increases, this effect would be magnified. Furthermore, as *n* approaches its limit, an FTA would approach multilateral free trade, which, under standard assumptions, is efficient and hence would lead to the highest attainable level of collective real income; since a hub-and-spoke would lead to a different outcome, it would be less efficient and would lead to a lower collective real income level. Its inefficiency would result from the trade barriers that would remain between spoke countries.

With this comparison of a hub-and-spoke system with the corresponding FTA in hand, it is appropriate now to turn to the second broad question: If an FTA is not an option because the United States instead offers only a bilateral to Mexico — and any succeeding applicants — what sort of a trading world would unfold? What would be the effects if a hub-and-spoke system were to develop?

A Hub-and-Spoke System Compared with the Status Quo

The Hub Country Would Benefit

The U.S. hub would benefit from an expanding hub-and-spoke regime. Indeed, benefits to the United States would increase even faster than those it would get from an expanding FTA, because it would get not only all the FTA benefits of free trade with Canada, Mexico, and all other spoke countries, but also the special benefit of preference in each spoke market in competition with other spoke countries. This would provide an attraction for industry to locate in the hub country, which would also be the only location in which industries could acquire inexpensive, duty-free inputs from all spoke countries.

Excluded Countries Would Lose

Excluded countries, such as Japan, would lose because of the increasing number of spoke countries, such as Mexico, that would discriminate against them in favor of the United States.

Existing Spoke Countries Might Gain or Lose

Each existing spoke might well acquire substantial gains from trade when it signs its own bilateral free trade agreement with the United States.

As the United States adds new spoke countries, however, each existing spoke country,

such as Canada, would be damaged by (i) the erosion of its preference in the U.S. market as new spoke countries also get free access to that market; (ii) the discrimination it would have to face in competition with the United States in each new spoke market; and (iii) further damage to its competitive position *vis-à-vis* the United States because U.S. producers would be acquiring duty-free inputs from other spoke countries.[15] (In an expanding FTA, it would have to face the first problem, but not the other two. Thus, for example, if existing partner Canada participates in a tripartite negotiation that consequently results in an expanded FTA, Canada will not thereby be able to protect itself against this first problem — that is, against some loss of privilege in the U.S. market acquired in the Canada-U.S. FTA. Canada will have to face this loss regardless, once Mexico and the United States negotiate any form of free trade. But Canada's participation in expanding the FTA to include Mexico can protect it against the other two problems.)

As *n* increases in a hub-and-spoke system, it is conceivable that the addition of new spokes eventually could damage an existing spoke enough to more than offset the original benefit it obtained from free trade with the United States, and thus leave it worse off than before it negotiated its original free trade bilateral with that country. It is not clear how likely this would be. In other words, it is not clear whether, as the United States adds new spokes, an existing spoke such as Canada eventually would find the net benefit from its original FTA with the United States more than, or less than, fully offset by accumulating costs. What is clear is that, for Canada or any other spoke country, the benefit from free trade with the United States would be realized immediately on the signing of its own bilateral FTA with the United States, while the accumulation of costs would occur over time as the U.S. hub adds new spokes. Thus, the fewer spokes the United States adds, the more likely it is that existing spoke countries would, on balance, retain a net benefit.

Finally, for an existing spoke country, the outcome may be worse than has so far been indicated, because new spokes may, in their bilaterals with the United States, be able to negotiate even better access to the U.S. market than the existing spoke was originally able to negotiate.

For example, new spokes may be able to acquire better relief from U.S. contingent protection or more favorable rules of origin. In that case, existing spokes would not only see their preference in the U.S. market erode, but would *also* now face discrimination in the U.S. market in competition with the new spoke countries. One way this might happen would be if the United States were to provide new Latin American applicants with special, particularly attractive access to the U.S. market because of their very low incomes and/or unstable domestic political conditions. In either case, the United States might view this trade policy as an appropriate form of foreign aid. Note that, in a sense, existing spoke countries would have to share in this foreign aid program. In some cases, they might find this justified; in others, they might not. Thus, the United States alone would be in a position to select the new foreign spoke countries to which it and other existing spoke countries would be providing such disguised foreign aid.

Why Would Countries Want to Become New Spokes?

A prospective new U.S. partner would prefer to join an FTA for essentially the same reasons cited above that an existing partner would prefer an FTA. If this is not an option, and only a spoke bilateral is offered, it will still have an incentive to say yes. This new spoke may, of course, be short-sighted, seeing only the immediate benefit of joining — free access to the U.S. market — but not the subsequent buildup of costs.

That is not the fundamental reason it is likely to say yes, however, since it will have an incentive to respond in this way even if it has perfect foresight and fully recognizes the accu-

mulating costs. Indeed, it will still have an incentive to say yes even if it can perfectly foresee that it is joining a hub-and-spoke process that will eventually make it, on balance, *worse off*. The reason it will respond in this way is that all the new spoke's answer will essentially do is give it the benefits of free trade with the United States. If it says yes, it gets them; if it says no, it does not. Its decision has little influence over the United States as that country adds spokes, leaving the trading system carved up into a preferential network.[16] That will or will not happen regardless; it is a cost the prospective new spoke will have to face whether or not it decides to join the hub-and-spoke system. The only decision for that country is whether or not to have free trade with the United States, and the answer to that — in terms of the economic issues discussed here — is yes. The new spoke may be unhappy with the whole process — and, in particular, with the dominant role the United States plays in damaging that spoke's trade prospects in the future — but it will still be in its economic interests to say yes.

Thus, the United States, which has the incentives described here for developing a hub-and-spoke system, is unlikely to run out of potential new spokes. This point can be put even more strongly: the more spokes the United States already has, the greater the incentive for excluded countries to participate. To confirm this, consider the situation facing country Z, the last holdout in a hub-and-spoke world. Since every other country is already in the hub-and-spoke system, Z is left facing the maximum amount of discrimination it can ever face. It has already borne all the costs of the hub-and-spoke system. Z's decision on becoming the last spoke by getting a bilateral with the United States is therefore a clear one. Saying yes involves only whatever benefit it may get from free trade with the United States, but no cost down the road. The question for Z is: In a world that has gone sour and in which it has already taken a beating, does it now want to recoup by cashing in a benefit?

Beyond this analysis, there is a further incentive for countries to say yes if they are offered a spoke bilateral and they regard it as the only way of liberalizing their trade with the United States. They may view a bilateral FTA with the United States as a way of reducing the risk of being the target of super-301 or some other form of U.S. unilateral action. Thus, like Canada in the last decade, their objective may not be just to get better access to the U.S. market, but also to reduce the risk of having their existing access damaged by unilateral U.S. action. This raises the question: Could aggressive U.S. unilateral policies developed during the 1980s now be used to increase the incentive for its trading partners to participate in a new U.S. hub-and-spoke bilateralism in the 1990s? In my judgment, that is not why these policies were introduced; nonetheless, there is a risk that they could be used in this way, perhaps inadvertently.

Other Effects of a Hub-and-Spoke System

The analysis above shows how a hub-and-spoke system would have different effects on different sets of countries. There is a good reason why a hub-and-spoke system might be *worse for essentially all countries concerned* than the analysis above implies, and a good reason why it would be *better*.

Retaliation by excluded countries. If a U.S. hub-and-spoke system were to develop, third countries that were excluded might retaliate. For example, Japan might form its own hub-and-spoke system in the Far East. This would damage all the countries involved in the original hub-and-spoke system in the Americas, including both the United States and its spoke partners. Moreover, such a further partitioning of the world trading system would damage the prospects for greater gains achievable under multilateral free trade.

Spillover benefits to all countries from large income gains in spoke countries. As already noted, income gains in spoke countries from

their free trade with the United States may be substantial. Whereas the gain in real income in Canada from its bilateral with the United States has been estimated at up to about 10 percent, the real income gain in Mexico from bilateral free trade with the United States could eventually run as high as several hundred percent. The spillover benefit from this increase in Mexico's income and, hence, purchasing power should be re-emphasized: It would, in turn, stimulate export industries and real income, not only in the U.S. hub, but also in other spoke countries such as Canada.

There is no way of knowing how substantial this benefit might be, nor is there any way of knowing how it would compare with the losses that might result from, say, Japanese or European retaliation. All that can be said is that such benefits are likely to be very important.[17] The expectation is, however, that these benefits to all participating countries would collectively be even greater in an FTA, since it would abolish more of the restraints to trade that limit real income growth.

Further Issues in a Hub-and-Spoke System

The development of a hub-and-spoke regime would raise several additional questions.

Would It Damage the United States' Incentive to Pursue Multilateral Free Trade?

Americans have always had an incentive for pursuing multilateral free trade, because, if it *could* be achieved, it would not only provide the highest real income for the world as a whole, but would also benefit the United States.[18] Once the United States starts to develop a hub-and-spoke system, that second incentive to pursue multilateral free trade would be weakened, because the United States would be giving up the special preferential benefits it would get from a hub-and-spoke system.

Could the Special Benefits to the United States from a Hub-and-Spoke System Lead to a New, Extended Form of U.S. Protectionism?

Even at present, it is difficult enough for the U.S. authorities to resist the pressure from strong lobbies wishing to see U.S. firms protected in the U.S. market. If some of the most substantial U.S. trading relationships were to be carved up into a hub-and-spoke regime, it might become even more difficult to resist a new, extended form of U.S. protectionism that would seek to protect U.S. firms against foreign competition, not just in the domestic U.S. market as always, but *also in the markets of spoke countries* where U.S. exporters would be protected by preferential treatment. This new form of protectionism by producers in the hub country might be called "domestic-export protectionism".

The problem with any such new U.S. protectionism is that it may be able to disguise itself as free trade easily and persuasively, precisely because it would be the defense of a policy (a U.S.-centered hub-and-spoke regime) that would include a substantial free trade element — namely, the removal of barriers to U.S. trade with spoke countries.[19]

What is wrong with this new, domestic-export protectionism? The answer is that, once a hub-and-spoke system is in place, U.S. business may want to defend it, even though, for broad foreign policy and other reasons discussed below, the United States has an interest instead in:

- the establishment of a Canada-Mexico-U.S. FTA; moreover, once that tripartite FTA is established, it is important that the United States continue along that route by including future partners, not as spokes, but as full members in that FTA; and
- vigorous support of multilateral free trade.

The reason why U.S. business operating under a hub-and-spoke system might resist either of these two policy directions — toward

an FTA or multilateral free trade — is that either one would eliminate its special preferences in spoke markets. (U.S. business is unlikely to consider the broad economic or foreign policy disadvantages of a hub-and-spoke system. Instead, it would simply lobby to protect its existing domestic and export interests — that is, to keep the hub-and-spoke system in place.)

Would the U.S. government and its agencies be able to resist this new protectionism? It may depend on how far the hub-and-spoke process has gone. Before any such development has taken place, it may be relatively easy to get U.S. business executives to support an FTA instead. Many will not recognize the difference in the two regimes, and those who do may be willing to favor an FTA because it provides a broader attack on trade barriers and therefore gives them greater freedom in internationalizing their operations. There are already reports of this sort of support for an expanded FTA.

However, once a hub-and-spoke system has become well established and U.S. business has internationalized its operations around this trading configuration, U.S. business may be reluctant to give up the protection such a regime provides in export markets. Moreover, the larger the number of spokes that have been established, the more difficult it may be to get U.S. business to give up this protection.

Even if there were only two spokes — Canada and Mexico[20] — there are three reasons for pessimism about Washington's ability to resist this new protectionism:

- It is becoming increasingly difficult to resist even traditional U.S. protectionism.
- It is not clear that the U.S. authorities will have sufficient will to resist a hub-and-spoke system, because, from a narrow business point of view, this sort of system provides special benefits for the United States.
- Even those in the United States who, for broader reasons, view multilateral free trade as more desirable may have difficulty in resisting the new U.S. protectionism because it may be able to disguise itself as free trade.

How Much Economic and Political Leverage Would a Hub-and-Spoke System Give the United States?

As the hub country, the United States might be able to put a great deal of pressure on one spoke country at a time through threatened modifications or reinterpretations of its bilateral agreement with that country. Thus, it might be able to exercise substantial influence, both economically and politically, over the spoke countries.

This is, in essence, an extension of the problem posed in 1972 by then Canadian Minister of External Affairs Mitchell Sharp: Once a relatively small country such as Canada has adjusted to a bilateral FTA with the United States by scaling up its industry to service the huge U.S. market, it becomes dependent on that market. It then has far more to lose than the United States from the termination of the FTA — or even from a less substantial shock to it.

So, very mild U.S. threats about even the possibility of termination or reinterpretation could put a great deal of pressure on Canadian business and thus on the Canadian government. In short, explicit or implicit threats would give the United States a bargaining lever that would be very difficult for Canada to resist and might conceivably be exercised to influence its policy in quite unrelated noneconomic areas.

In the Canadian case, the answer to this has been:[21] True, because of the FTA, a more open Canadian economy would be more vulnerable to U.S. trade action. However, the FTA makes such U.S. action less likely, since it imposes greater constraints on the United States. Moreover, Canada might draw on counterthreats of its own in the face of U.S. threats. For example, it holds a substantial reserve of oil and other resources that will be

in heavy future demand by U.S. industry. Termination of the FTA would end its conditional guarantee of Canadian oil supplies to the U.S. market. In addition, the Canadian government, in its tax policies, exercises considerable control over U.S. investment in Canada. Thus, while the United States holds Canadian markets hostage, Canada holds U.S. sunk capital. If the United States were to consider trade restraints, Canada could consider increasing its tax on foreign investment. The potential damage that the United States could face would likely provide an effective deterrent and also give the U.S. government a strong argument to fend off domestic protectionist pressure. (No one would suggest that Canada — or, for that matter, the United States — would benefit from such an economic war, or even the threat of it. The only point here is that Canada would have some defense.)

It is not clear that other spoke countries would have as effective an answer to U.S. pressure — although the risk of political instability in those countries could act as a strong deterrent to any U.S. threat of trade action. Thus, it is possible that, because of the bargaining power a hub-and-spoke would give the United States, Latin Americans might come to view it as a means by which the United States could extend its hegemony over the entire hemisphere. This is one important reason for U.S. rejection of this type of regime in favor of an FTA in which all countries are equal partners, and none has a privileged position.

Would a Hub-and-Spoke System Result in Inconsistent, Trade-Distorting Policies?

Because a hub-and-spoke system would leave restraints on trade between spoke countries, it would lead to trade distortion and inefficiency *even if all of the bilateral spoke agreements with the United States were mutually consistent — indeed, even if they were all identical.* But it is hard to see how separate bilaterals could be made consistent. An example is a different treatment of energy that would be almost certain in U.S. bilaterals with Canada and Mexico. As another example, in a Mexico-U.S. bilateral, would Mexico be given U.S. status in autos or the quite different Canadian status now provided in the Canada-U.S. bilateral made up of the auto pact and the Canada-U.S. FTA?

Some inconsistencies may not matter. For example, it would be immaterial if a Brazil-U.S. bilateral did not have a provision for Brazilian supply of oil to the United States similar to the condi onal commitment by Canada in the Canada-U.S. bilateral, since Brazil does not supply oil to the U.S. market in any case. Other inconsistencies that do distort prices and trade may, however, lead to substantial reductions in efficiency.

With Which Countries Should the United States Negotiate Bilaterals?

If there is a larger number of applicants for bilaterals than U.S. negotiators can deal with, the United States will face a difficult choice: With which applying countries should it negotiate? This raises the whole question of U.S. favoritism to countries that get a bilateral negotiation versus those that are delayed.

Michael Aho describes some implications of the last three problems:

> If...nations...negotiate bilateral agreements offering mutually incompatible privileges, predictability and stability would be destroyed for all states....The essence of bilaterals is to play favorites, thus creating foreign policy problems with those that are discriminated against. Inevitably, some countries will be left out. How will they be chosen and who will decide? In the United States, Congress will have to play a role. Thus, domestic political problems are created as well. Consider how members of Congress will be whipsawed by foreign countries and individual industrial interests before agreements are approved. Then, once agreements go into effect, Congress will be pressured to withdraw trade preferences or withhold further liberalization from countries deemed to be acting inconsistently with U.S. foreign policy objectives or to be increasing competition for politically powerful domestic sectors. Trade policy would spring from "low-level" to "high-level" foreign

policy. Do members of Congress want to get involved in such micromanagement of trade and foreign policy initiatives? Does Congress want to devote the time, resources, and political will to review, oversee, and legislate a series of bilaterals with all of the attendant political pressures that they entail?[22]

Mexican-U.S. Free Trade: A Hub-and-Spoke System or an Expanded FTA?

The conclusion so far is that, as a broad future direction, the efforts of the United States and all countries in the Americas should be to liberalize their trade through an expanding FTA, rather than, perhaps inadvertently, through the development of a hub-and-spoke system of separate U.S. bilaterals. It is clear from the above observations why this is in the interests of Canada, Mexico, and other potential U.S. partner countries. But why would it be an objective of the United States, which, according to our analysis of hubs and spokes, has an economic interest in such a system?

There are several broader reasons for the United States to prefer an FTA. While some are recurring themes throughout this *Commentary*, a few deserve special note here in the context of the upcoming Mexican negotiations.

First, since an FTA would avoid the trade distortions and inefficiencies that would result from a hub-and-spoke agreement, it would provide the participating countries collectively with higher real income. It would also move them closer to a free, efficient international marketplace — a point of particular importance for Mexico, since an FTA would strengthen and consolidate its recent substantial moves toward free markets.

Second, there is the broader question of foreign policy. Because of its central location and economic size, the United States will dominate even a completely symmetric FTA in the Americas. It is not in the United States' foreign policy interests to be perceived as further dominating the economic activity of its neighbors by developing a hub-and-spoke trading structure that will leave markets in the Americas carved up into a patchwork of what it may view as preferences but its partner countries will view as discrimination. Compared with a tripartite FTA, such a system would not only benefit the United States at the expense of Canada, Mexico, and any other future U.S. partners, but would also provide the United States with a degree of economic and political influence and leverage that could expose it to severe criticism.

Finally, the U.S. public should be willing to accept an FTA, rather than a Mexican bilateral, because the difference between the two is the free trade between Mexico and Canada that would exist under a trilateral FTA, but not in a hub-and-spoke system. And this is, on the face of it, not a major consideration. In comparison with U.S. liberalization of more than US$160 billion of annual two-way trade with Canada in the Canada-U.S. FTA, why should any American oppose the liberalization of Canadian-Mexican trade that is less than 2 percent as large, and in which the United States does not even directly participate? (Canada-Mexico trade is undoubtedly larger than this, since much of it now passes through its natural U.S. conduit and is not captured in the trade statistics. Nonetheless, to the public, it seems very small.) Thus, it should be easy to sell the choice of an FTA over a Mexican bilateral to the U.S. Congress and public — if, indeed, they even ask — as of little consequence, even though it will be of great consequence, for two reasons.

First, the decision on Canadian participation may well mark a watershed. The United States will be embarking on either the hub-and-spoke route or the FTA route.[23] If and when more partner countries are added down the road, the difference between the two regimes will take on increasing significance, especially if the network of U.S. partners is extended across the Pacific.

Second, the most important locale for competition between Canada and Mexico will not be in their bilateral trade. Instead, it will be in the U.S. market, as the relative size in their trade flows confirms. And the question of how Mexican and Canadian producers will be able to compete in the U.S. market with one an-

other — and, more important, with U.S. producers — will be influenced by whether or not there is an FTA or a hub-and-spoke configuration. (Paradoxically, the major effect in the U.S. market of a hub-and-spoke configuration would not be to change the competitive position of Canadian versus Mexican producers so much as to make both less competitive with U.S. producers who alone would be able to acquire inexpensive duty-free imports from anywhere in North America.)

Implications for the Mexican Free Trade Negotiations

Negotiating free trade with Mexico will involve many complications. I concentrate here on just one: What does the analysis above tell us about how these negotiations should be structured? From the point of view of the world trading system, the conclusion is that the negotiations should be trilateralized to include Canada, with the task being to negotiate Mexican entry into the Canada-U.S. FTA.[24] However, this would not be a simple task. For example, in one industry alone — autos — difficult issues have already been noted: Would Mexico be granted the present status of the United States, or the quite different status of Canada, or some status between the two? More broadly, what parts of the present Canada-U.S. FTA would Mexico find unacceptable? What issues would the United States and Mexico wish to cover that are not included in the Canada-U.S. agreement?

The result of such a tripartite negotiation would be a core of central provisions in the existing Canada-U.S. FTA on which the three countries could agree. This would represent a new Canada-U.S.-Mexico FTA. It would be overlaid by a hub-and-spoke set of bilateral provisions on which only two countries — the United States and either Mexico or Canada — could agree. These latter two-country provisions would mean that Canada and Mexico would each, in a sense, have its own separate "bilateral" with the United States. For example, the Canadian "bilateral" would be those provisions in the Canada-U.S. FTA to which the Mexicans could not agree. One objective of the negotiators — admittedly a difficult one to achieve in anything like a complete way — would be to avoid altering the existing Canada-U.S. FTA. This would be a matter of principle and precedent to prevent a future reopening of any existing FTA — with the politically divisive debate this could trigger in the then existing FTA countries — every time a new member is added.

To minimize the risk that the United States would develop by default as the center of a hub-and-spoke system, it would be essential that the core provisions on which all three countries agree be maximized, and that the bilateral hub-and-spoke provisions on which only two countries agree be minimized. One method of doing this would be to make temporary as many of the Mexican hub-and-spoke provisions as possible, and then phase them out — or into conformity with the Canada-U.S. FTA, at which point they would then expand the core.[25] As this took place, the tripartite accord would increasingly have its core of desirable FTA characteristics dominate its undesirable hub-and-spoke characteristics.

While such a tripartite negotiation of an expanded FTA is the preferred route, suppose that it is not now feasible and that the United States instead proceeds to a bilateral negotiation with Mexico. Should Canada play a role? In my judgment, *it is essential for Canada to be at the table*, for two broad reasons.

First, Canada's interests must be protected. One example illustrates the multitude of such issues that will arise: The Maquiladoras will have to be dealt with appropriately — as the duty drawback issue was dealt with in the Canada-U.S. FTA — to ensure that Canada (and the United States as well) do not face a costly trade distortion that will induce into Mexico a substantial amount of third-country investment that would otherwise locate in Canada or the United States.

Second, Canada has to establish as strong a "shadow core" as possible — that is, to ensure that as many of the provisions in the Mexico-U.S. bilateral agreement as possible

are the same as the corresponding provisions in the Canada-U.S. FTA.[26] The result will still be a hub-and-spoke arrangement, but this defense of the shadow core will simplify the task in the future of folding the two U.S.-centered bilateral accords into a tripartite FTA with minimal negotiating difficulty and residual hub-and-spoke overlay.

Without a strong shadow core, the two U.S. bilaterals cannot be consistently "bridged" by a Canada-Mexico bilateral later. Instead, a whole new trilateral negotiation would be required — or else the three-country trading relationship would be left riddled with inefficient, trade- and investment-distorting inconsistencies. Moreover, once the United States has signed more than two or three bilaterals, they can no longer be bridged with spoke-to-spoke bilaterals simply because too many would be required.[27]

These considerations can be summarized into a few broad conclusions. All three countries should be clear that their eventual objective is an FTA, not a hub-and-spoke system. Thus, Canada should be at the table, ideally to help negotiate the extension of the Canada-U.S. FTA to include Mexico or, as a second best, to protect the shadow core by ensuring that any Mexico-U.S. bilateral conforms as closely as possible to the Canada-U.S. FTA. The more that Mexico and the United States are committed to the long-run objective of an expanded free trade area rather than a hub-and-spoke system, the more they will welcome the Canadian defense of the shadow core, and the less conflict and complication the Canadian presence will add to this negotiation.[28] It is hard to see how the United States could reject a strong Canadian presence in this role without being perceived as seeking to create a U.S.-centered hub-and-spoke regime.

A Japanese or European Spoke in the U.S. Wheel?

So far, we have considered only spokes in the Americas. But what about a U.S. bilateral trade agreement with Japan? Those who are tempted to say it could never happen should remember that "never" used to be defined as "not within 50 years"; now it is 6 months. In August 1990, the Deputy Chief Secretary of the Japanese Cabinet warned that, without a free trade pact with the United States, Japan would face the danger of being excluded from regional blocks in Europe and North America.

If, through a Japan-U.S. bilateral, the United States were to extent its hub-and-spoke network across the Pacific, it would no longer be just carved-up trade in the Americas, with its important cumulative effect. With a Japanese bilateral, the United States would have created a hub-and-spoke system right at the heart of world trade — the Japanese trade artery is second only to the Canada-U.S. artery.[29] With separate bilaterals covering these two trade flows, the problem would no longer be the one posed by the development of a hub-and-spoke regime in the Americas — namely, damage to U.S. partner countries, which might not be too serious if, say, only one more relatively small South American spoke were to be added, but which would cumulatively build up if a series of new spokes were to be added. Instead, the addition of this single Japanese spoke would have immediate, profound effects on all the existing U.S. partners.

The same is true of a U.S. bilateral with the European Community (EC). This is a particularly interesting case on which to speculate, not just because of the size of the EC, but also because the EC is itself a hub in a very special hub-and-spoke regime. Thus, the United States would be a spoke in the EC wheel just as the EC would be a spoke in the U.S. wheel.

Summary and Further Conclusions

A focus of trade policy debate in recent decades has been whether free trade agreements are beneficial, and whether they make it easier or more difficult to move toward multilateral free trade. While that issue still remains an important one, another has now come to the fore: With the possibility that the United States will now be negotiating free trade with Mexico and

possibly other countries in the Americas, what *form* will free trade agreements take?

There is now a substantial risk that, by negotiating separate bilateral agreements with Mexico and then with other individual countries in the Americas, the United States will reconfigure hemispheric trade in such a way that it alone, as the hub, will be trading freely with all its partners but they will not be trading freely with each other. Whether this is done inadvertently or by default, the resulting hub-and-spoke system will have two broad effects:

- *(1) The free trade effect.* Free trade with the United States can initially be expected to provide substantial benefits for each bilateral partner, as well as for the United States, as both give up their protection against each other.[30] The potential free trade benefits to partner countries should be re-emphasized: increases in productivity could increase real incomes in participating Latin American partner countries by several hundred percent, compared with the estimated potential increase of up to about 10 percent of real income in Canada from its FTA with the United States.
- *(2) Protection in foreign markets for the United States.* A hub-and-spoke system would leave trade in the Americas carved up into a network of preferences for the United States. In effect, the United States would be protected in each partner's market against all other partners as well as the rest of the world. This would give it special economic benefit, as well as increased political influence. However, much of this benefit would be at the expense of its bilateral partners. In particular, each partner would be damaged by the discrimination it would face in other partners' markets in competition with the United States. This second effect would erode the free trade benefits each partner would receive in (1) above.

In short, each time the United States signs a bilateral agreement with a new partner, that partner and the United States are likely to get free trade gains. However, because of its exclusion from the new FTA, any *existing* U.S. partner would incur losses. To illustrate, if the United States signs a bilateral with new partner Mexico, existing partner Canada would not get the free trade benefits of better access to Mexican markets. Instead, it would get worse access because of the discrimination in the Mexican market it would have to face in competition with the United States. Moreover, Canadian industry would not get the free trade benefits of less expensive Mexican inputs that would make it more competitive in world markets. Instead, it would have to face stronger competition in North America and elsewhere from a U.S. industry that *would* be acquiring these low-cost Mexican inputs.

The more spoke bilaterals the United States adds, the wider its domain of market preferences and inexpensive input supply, and thus the more substantial the advantages of the United States as an industrial location. At the same time, as the number of spoke bilaterals increases, the discrimination that a U.S. partner would have to face becomes more widespread. It is even conceivable that its original gains from free trade with the United States could be more than offset by costs down the road, leaving the partner worse off than before this process began.

Despite this, the United States may continue to get new spoke applicants seeking a bilateral. The main reason is that essentially the only effect of such a bilateral on the applicant will be to provide it with the benefits of free trade with the United States. Whether or not it gets its own bilateral, the applicant will have to face the costs as the United States signs bilaterals with other countries.

The problems associated with a hub-and-spoke system would not exist under an expanding FTA, which would provide the free trade benefits in (1) above to all participating countries without the protection effects in (2).[31] In an FTA, the United States and its partner countries would have completely equal status. All would trade freely with each other, and there would be discrimination against

none. Thus, the single most important conclusion from this study is that the extension of free trade across the Americas should be through the expansion of a single FTA, rather than through a hub-and-spoke sequence of U.S. bilaterals.

The reasons that such a development would be in the interests of all parties concerned can be summarized as follows:

Canada's Interest

Canada should favor negotiating an expanding free trade area, rather than standing aside and allowing a U.S. hub-and-spoke system to develop, for the following reasons:

- Canada's gains from its present FTA would likely be augmented by its gains from extending the FTA to include Mexico. This would be preferable to watching its present FTA gains eroded by the hub-and-spoke expansion of a U.S. preferential network.
- Canadian participation in the negotiations would better allow it to protect its interests — for example, by ensuring an appropriate treatment of the Maquiladoras to prevent a distortion of North American free trade and investment, as well as discrimination against Canada in the U.S. market in competition with Mexico.
- An FTA would prevent the United States from having an even more dominant economic role in the Americas than it will have in any case.

Mexico's Interest

Mexico should also reject the hub-and-spoke configuration for precisely the same reasons as Canada, since, once Mexico becomes a U.S. free trade partner, it will find itself in exactly the same situation as Canada when the United States considers further bilateral agreements with, say, Chile or Brazil.

For Mexico, the question is: If the United States continues to extend its free trade domain with a sequence of bilaterals, rather than within the discipline and consistency imposed by an expansion of an FTA, what is to prevent it from offering some other Latin American countries better access to its market than Mexico may have been able to negotiate? As a hypothetical example, the United States might provide such better access for, say, Brazil, perhaps as an implicit form of foreign aid to offset the current high oil price that puts Brazil at a severe disadvantage *vis-à-vis* Mexico. But if and when the price of oil comes down again, Mexico would be left having to face continued discrimination in the U.S. market in competition with Brazil.

The United States' Interest

There are also reasons why it is in the United States' interest to favor expansion of the FTA, rather than a hub-and-spoke. It is true that, because of the preferences it would receive, the United States would benefit more from a hub-and-spoke. However, it would get these special benefits only because its bilateral spoke agreements would co-opt each partner country into providing the United States with protection by discriminating against other partners.

With gains from an expanding FTA, and a dominant geopolitical role in the Americas assured by the size of its economy, it is inappropriate for the United States to be perceived as attempting to increase this dominance and economic benefit by developing a hub-and-spoke trading structure that would leave markets in the Americas carved up into a patchwork of what the United States would view as preferences but that its partner countries would view as discrimination. Moreover, there might well be unpredictable economic costs down the road if its partners, seeing it develop a special preferential position, were to seek to take some collective action to pressure the United States. If this pressure were to be to enclose all the bilaterals into an FTA, the United States should welcome it.[32] There would, however, be substantial and unnecessary problems involved in any negotiation,

because separate bilaterals are almost certain to have inconsistent provisions. Moreover, there would be economic and political costs of negotiating free trade in a two-stage process — a bilateral followed by a renegotiation into an FTA — rather than a one-stage process — entry into an FTA. There would be a political cost, because a possibly divisive free trade debate might have to be undertaken a second time; and an economic cost, because there would be two sets of adjustment costs — the first required by the bilateral and the second by the later renegotiation into an FTA.

It is always possible that the United States' partners may take far less favorable collective action to exercise pressure on it — perhaps even action that would be damaging. The problem is that, when collective action is taken, its eventual form cannot always be predicted. It is possible, for example, that by invoking a fair trade, level-playing-field defense, the United States' partners might take action in some protectionist direction that would damage both the United States and the partners themselves. The problem is that the level-playing-field argument, so often abused in other contexts,[33] would have some validity here as a criticism of the United States, since the trading system itself would, by inadvertence or design, have been structured to provide the United States with a special advantage over its partners.

A final U.S. concern should be: What would happen if there were to be more applicants for a U.S. bilateral than U.S. negotiating resources could accommodate? The United States would then be forced to discriminate — in saying yes to some countries, no to others — in offering a negotiation that would itself be discriminatory.

In my view, it was never the United States' explicit intention to institute a hub-and-spoke system with these sorts of complications; nor, when it is fully understood, would the United States wish to have such a system develop.

This means that if the preferred approach in the upcoming negotiations — namely, including Mexico in an expanding FTA — is not feasible, and the only option is a second-best bilateral with Mexico, then it should be carefully structured to ensure that it can soon be folded into the Canada-U.S. FTA. A clear commitment to this sort of closure by the United States and any new partner is important, on a specified timetable. The longer the delay, the more difficult closure becomes; clearly, folding two or more bilaterals into an existing FTA becomes much more difficult than one. This precise commitment to rapid future closure is also important to prevent the development of a new disguised form of U.S. protectionism that, taking account of only a narrow definition of U.S. economic interests, might seek to maintain a discriminatory hub-and-spoke system and thus erode U.S. support for multilateral free trade.

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Questioning Two Traditional Beliefs about an FTA

An FTA is believed to be preferable to a customs union because it allows each partner

freedom to liberalize its trade with the rest of the world. While this remains true so long as each partner is liberalizing its trade unilaterally, problems arise if it is liberalizing its trade with third countries bilaterally or in any other reciprocal way. Then, the hub-and-spoke problems of overlapping free trade areas arise. To avoid these problems, there is an advantage of a sort of "customs union discipline" that requires any new member to conform to the provisions of the existing members — immediately, or after an appropriate phase-in period.

Another commonly held belief — often cited in the Canada-U.S. case — is that one advantage of bilateral over multilateral trade liberalization is that participating countries can tailor the agenda for liberalization to their own special needs by focusing their attack on those trade barriers they find most costly. While such tailoring is an advantage so long as there is only one FTA, it raises two problems if there is more than one overlapping agreement. First, it creates inconsistencies between bilaterals that would exacerbate the inefficiencies that would result in any case from even a perfectly consistent set of overlapping bilaterals. Second, without adequate foresight, a potential new partner might fall into a "tailoring trap". As a hypothetical example, this would occur if Mexico were to seek a bilateral with the United States alone because it judged that such an agreement could be tailored to satisfy its special needs. However, any advantage Mexico achieves from this might well be offset by losses if future U.S. partner countries were consequently able to tailor their bilaterals, and did so at Mexico's expense.

Notes

* I am indebted to Michael Aho and Peter Morici for their extremely helpful comments, although they should not be held responsible for the views expressed here. I also wish to express my appreciation to Yvonne Adams for her untiring efforts far beyond the call of duty.

1 The term "trade diversion" has two different definitions. This *Commentary* uses the one that recognizes that diversion involves both the cost described in this example plus a benefit, because, as the domestic U.S. price falls toward the world price, there are increases in efficiency in U.S. domestic consumption and production.

2 One reason this numerical example is oversimplified is that it assumes that the United States is a price taker.

3 This example initially follows the literature by focusing on the direct effects of an FTA on excluded countries, deferring the discussion of its secondary effects — namely, the benefits it could generate for these countries because it raises the real income of the partner countries in the FTA.

4 Given the definition of diversion used here, this condition should more precisely be stated: If the benefits of both trade creation and trade diversion exceed the costs of trade diversion.

5 This is true from the collective point of view of all countries in the world. One way of seeing this is that the absence of trade diversion under multilateral free trade means that all goods are produced at their lowest-cost locations. Thus, multilateral free trade satisfies a necessary condition for an efficient outcome, generating the largest collective worldwide real income level. Under standard assumptions — in particular, in the absence of changes in the terms of trade —multilateral free trade is also superior for members of the FTA.

6 A free trade agreement may or may not be a regional grouping. The Canada-U.S. FTA is regional, but the European Free Trade Association is not, nor would be a super-GATT. If Chile, say, were to join a Canada-Mexico-U.S. FTA, then the resulting broader FTA would no longer be regionally circumscribed. Similarities in culture or language may make it more likely that countries in the same region will form an FTA than countries that are geographically dispersed. Moreover, lower transport costs — other things being equal — make the gains from trade greater for countries in the same region. For example, one of the reasons that there are greater gains from trade for the United States in forming an FTA with Canada than with, say, Brazil, is because in the Brazilian case more of the gains from trade would be dissipated in higher transport costs. Yet, despite these incentives for regional groupings, FTAs are often not regional at all, but are formed for other reasons. An example was Commonwealth Preference, a "partial FTA" among distant member countries with a common political tie.

7 To my knowledge, this idea is attributable to Martin Richardson, in an unpublished manuscript on "Trade Diversion and Endogenous Tariff Formation."

8 For detail, see Ronald J. Wonnacott, *U.S. Hub-and-Spoke Bilaterals: An Inferior Form of Trade Liberalization* (Washington, D.C.; Toronto: Canadian-American Committee, forthcoming), Appendix A.

9 This hub-and-spoke system is the same "two-sided triangle", or hub with two spokes, that I earlier analyzed as a trade strategy for Canada, with the important difference being that Canada, rather than the United States, was viewed as the potential hub, with bilateral Canada-U.S. and Canada-Europe agreements — the latter in manufactures only — being the spokes (see Ronald J. Wonnacott, "Canada's Future in a World of Trade Blocs: A Proposal," *Canadian Public Policy* 1 [Winter 1975]: 118–130; and idem, "Presidential Address: Controlling Trade and Foreign Investment in the Canadian Economy — Some Proposals," *Canadian Journal of Economics* 15 [November 1982]: 574–576.) Such a Canadian hub with U.S. and European spokes would have put Canada in a preferred position, because, for example, it would have acquired preference in the European market in competition with the United States. It is not at all clear that the United States would have been prepared to accept this arrangement, and concern about U.S. reaction may be one reason that this did not become a Canadian policy objective. Ironically, it is now the United States that may be pursuing this policy. (Other complications that made this policy a non-starter for Canada are detailed in the sources cited above.)

At the same time that I was applying this analysis in 1990 to the hub-and-spoke system that could develop as a result of negotiations with Mexico, Richard Lipsey was addressing the same problem independently (see Richard G. Lipsey, *Canada and the U.S.-Mexico Free Trade Dance: Wallflower or Partner?*, C.D. Howe Institute Commentary 20 [Toronto: C.D. Howe Institute, 1990], pp. 4–5). Some of the issues that arise in a hub-and-spoke system are also implicit in Peter Morici, "The Implications for the Future of U.S. Trade Policy," in Peter Morici, ed., *Making Free Trade Work: The Canada-U.S. Agreement* (New York: Council on Foreign Relations, 1990), p. 147.

10 The United States would, of course, get preference in each of these markets in competition with third countries as well. But this is equally true in an FTA.

11 Thus, one Canadian benefit from the Canada-U.S. FTA — namely, more competitive access to the U.S. market — would be eroded. This is one of the reasons why Canada should participate in the Mexico-U.S. negotiations to prevent the development of a U.S. hub-and-spoke system.

12 It is important not to forget that while an expanding hub-and-spoke system raises problems — and serious ones — for an initial spoke country such as Canada, they are not as serious as the problems Canada would face if the United States were developing as the hub with a lot of bilateral spoke agreements, *but none with Canada*. In that case, Canada, like Japan in the example above, would be an outsider right from the beginning. It would enjoy no initial benefits from a bilateral FTA with the United States and, like Japan, it would be damaged by increasing levels of discrimination each time the United States added a new spoke — or alternatively expanded an FTA that continued to exclude Canada. Thus, the argument in the text is not that Canada should have rejected a bilateral FTA with the United States in the first place. Rather, once Canada did negotiate a bilateral FTA with the United States, it has been very much in its interest to have this expanded into a widening FTA, rather than a U.S. hub-and-spoke system.

13 Indeed, this increase in Mexican purchasing power makes it possible for Canada to gain, rather than lose, if Mexico becomes a spoke in a U.S. hub-and-spoke system. This would occur if increased demand in Mexico were to generate a sufficient increase in Canadian exports either (i) through a direct increase in Canadian exports to Mexico or (ii) through an increase in Canadian exports to the United States, to be used as inputs by U.S. producers exporting to Mexico. A hub-and-spoke system would encourage this second indirect effect, since Canada's only free trade access to the Mexican market would be via the United States — following whatever processing might be required there to meet rules of origin at the Mexican border. Thus, some of the expanding Canadian exports to Mexico that would develop in a tripartite FTA would, in a hub-and-spoke system, be redirected instead through the United States. Since this redirection is likely to dissipate some of the gains from trade, a hub-and-spoke would offer less than an FTA. In short, even if expanding trade based on increased Mexican purchases were to make a hub-and-spoke system beneficial for Canada, it would still be an inferior policy to a tripartite FTA.

14 A broader view of U.S. economic interests and foreign policy objectives will be taken below, where it will be argued that a hub-and-spoke system is not better for the United States.

15 This damage to existing spokes when the United States adds new ones is sometimes referred to as the "recontracting problem". See, for example, Morici, "The Implications for the Future of U.S. Trade Policy," pp. 147, 169.

16 A major purpose of this *Commentary* is to get the United States to listen to, and be influenced by, its partners. But, in the absence of any form of collective action by these partners, the United States may not have to listen. To see how important this issue may be, the *Commentary* examines what happens if the United States does not listen, and any individual spoke country thus has little or no influence over the United States as it negotiates new spoke bilaterals.

17 Might these gains be augmented by political benefits if free trade with the United States leads, via a greater commitment to freer markets, to increased political stability in some Latin American spoke countries?

18 This benefit to the United States holds under standard assumptions — in particular, the assumption that the United States would not be damaged by an adverse change in its terms of trade, or at least the weaker assumption that the United States would not be damaged enough to upset this conclusion. This weaker

assumption would be difficult to defend if the United States were the only country with terms-of-trade influence. But it is less difficult in a world in which both Europe and Japan have similar influence.

19 The same problem of export protectionism arises in an FTA, and there have been examples of producers' viewing the main point of an FTA as the protection they receive against third-country competition in partners' markets. But this problem would be even more serious in a hub-and-spoke system, because the U.S. hub would get a stronger set of preferences — that is, more substantial protection in partners' markets — than it would in an FTA.

20 There is already another spoke: the U.S.-Israeli agreement. That, however, was largely a politically motivated agreement. While it does have economic implications that are substantial from Israel's point of view, it covers a sufficiently small volume of trade to prevent it from disturbing the present analysis.

21 See Ronald J. Wonnacott, *Canada's Trade Options* (Ottawa: Economic Council of Canada, 1975), pp. 97–98.

22 Michael Aho, "More Bilateral Trade Agreements Would Be a Blunder: What the New U.S. President Should Do," *Cornell International Law Journal* 22 (Winter 1989): 31.

23 True, it may be possible in the future to shift from one route to the other, but only with increasing difficulty.

24 For further complications in any negotiation with Mexico and economic reasons why it would be in Canada's interest to participate — in addition to the importance of keeping the United States from developing a hub-and-spoke system — see Lipsey, *Canada at the U.S.-Mexico Free Trade Dance*; and Ronald J. Wonnacott, *Canada and the U.S.-Mexico Free Trade Negotiations* C.D. Howe Institute Commentary 21 (Toronto: C.D. Howe Institute, 1990).

25 This is the suggestion of Michael Hart in *A North American Free Trade Agreement: The Strategic Implications for Canada* (Ottawa: Center for Trade Policy and Law and Institute for Research on Public Policy, 1990), p. 99; and Lipsey, *Canada at the U.S.-Mexico Free Trade Dance*, pp. 9–10. Lipsey's suggestion is to phase essentially everything into the core, over whatever time period may be necessary, perhaps even over 50 years for the more contentious provisions.

26 An example will illustrate the difference between a core and a shadow core. If there is a tripartite FTA, and it eliminates all tariffs within North America, then this would be a core provision, since all three countries would be agreeing to precisely this provision. If there are only two bilateral agreements, and they eliminate tariffs — that is, Canada-U.S. and Mexico-U.S. — then this tariff elimination is only a shadow-core provision. Canada and Mexico would also have to agree to eliminate tariffs on Canada-Mexico trade before it would become a core provision. If there is a strong shadow core in two bilateral agreements, then it is far easier to fold these two bilaterals into an FTA. All that is necessary is a Canada-Mexico bilateral agreement to eliminate tariffs on their trade. The two existing bilaterals — Canada-U.S. and Mexico-U.S. — need not be touched. Compare this with the situation if there is no such shadow core — for example, Canada-U.S. trade has a zero tariff, while Mexico-U.S. trade has a non-zero tariff in their bilateral. Then, it would be more difficult to fold these inconsistent provisions into a three-way agreement, and a whole new negotiation would be required.

27 As noted by Lipsey, *Canada at the U.S.-Mexico Free Trade Dance*, p. 7.

28 The Canadian presence will tend to make the negotiations more difficult and time consuming, simply because another party is at the table. However, it may be easier to negotiate by starting within the discipline of the existing Canada-U.S. FTA provisions, rather than to start from scratch to create a new Mexico-U.S. agreement.

29 Each is more important than is the U.S. trade artery with any individual European country — although U.S. trade with the EC taken as a whole is, of course, the most important.

30 I repeat the warning that holds throughout this analysis: These benefits hold under standard assumptions, and provided diversion costs are not substantial enough to more than offset benefits. Special circumstances can be postulated in which net benefits would not follow.

31 Except, of course, for the protective effects against third countries that would exist under either regime.

32 There might be other ways of exerting pressure on the United States. It is even conceivable that, in order to prevent the United States or any other country from establishing a special preferential position, there might be a move in the GATT to reform Article XXIV to preclude any country from participating in more than one substantive FTA. However, this would involve problems. True, "substantive" could be appropriately defined, just as other substantive requirements in Article XXIV are defined. Moreover, this definition could exclude the Israeli-U.S. agreement, leaving the United States free to maintain that bilateral regardless. It might be more difficult, however, to exclude some of the bilateral spoke-like arrangements that the EC has developed.

33 An example of this abuse would be the argument that Mexico should continue protection against the United States because higher U.S. productivity would mean that Mexico would not be competing on a level playing field.

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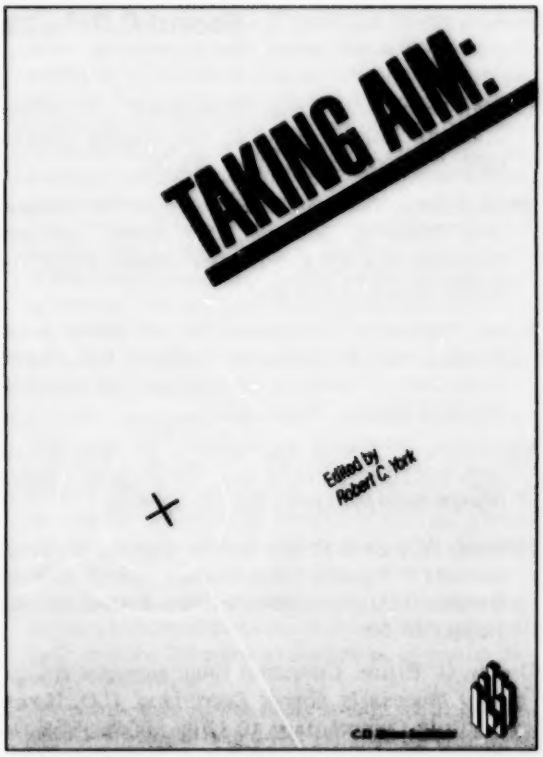

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